Company In-Depth

20 April 2007 | 28 pages

Pantaloon (PART.BO)

Rating change ☑
Target price change ☑
Estimate change ☑

Upgrade to Buy: First Mover Advantage to the Fore

- **Upgrade to Buy** — After being negative on Pantaloon's shares for a long time, we are now turning positive. The stock has underperformed the Sensex by 12.4% in the past 12 months. We are upgrading to Buy (from Sell), capturing value of subsidiaries that are scaling up quickly and continued growth in the core business (forecast an earnings CAGR of 35%).
- **Price target Rs500** — Our price target is based on sum of the parts valuation. We now capture the value of Home Solutions (Rs60/share) and Future Capital (Rs50/share) subsidiaries and revise per share target of parent from Rs212 to Rs390, based on 30x P/E, rolled forward FY08E.
- **First mover advantage playing out** — Retail space locked in at lower-than-average market rents, strong brands, judicious product mix and understanding of Indian consumers developed over years are sources of competitive advantage and should protect growth and margins as competitive intensity picks up.
- **New format roll out judiciously managed** — Store formats have increased from four to 12 over last 18 months. Pantaloon used resources judiciously, and has not hesitated from curtailing underperforming formats. Recently opened "Home Town" store impresses us, and it could likely evolve as the next "big" format.
- **Value unlocking from subsidiaries** — Pantaloon's subsidiaries (media, logistics, brand-management, e-tailing) are being scaled up. It is looking to dilute equity in some of these over next 2-3 months to fund growth, which will unlock value, not yet captured in our target price.

Buy/Medium Risk	**1M**
from Sell/High Risk	
Price (18 Apr 07)	Rs398.95
Target price	Rs500.00
from Rs212.00	
Expected share price return	25.3%
Expected dividend yield	0.2%
Expected total return	**25.5%**
Market Cap	Rs56,128M
	US$1,346M

Price Performance (RIC: PART.BO, BB: PF IN)

See Appendix A-1 for Analyst Certification and important disclosures.

Figure 1. Pantaloon – Valuation Summary

Year to	Net Profit	FD EPS*	EPS Growth	P/E	Adj.P/E**	DPS	Yield	RoE
31-Mar	(Rs Mils.)	(Rs)	(%)	(x)	(x)	(Rs)	(%)	(%)
2005	386.0	3.5	69.4	116.8	85.4	0.5	0.1	24.4
2006	641.6	4.9	38.5	84.3	61.7	0.5	0.1	17.1
2007E	1,449.4	10.0	105.6	41.0	30.0	0.5	0.1	19.7
2008E	1,889.8	13.0	30.4	31.4	23.0	0.7	0.2	21.1
2009E	2,394.4	16.5	26.7	24.8	18.1	0.8	0.2	22.4

Source: Company Reports and Citigroup Investment Research estimates
*Pre-exceptional EPS; ** Adjusted for value of subsidiaries

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Fiscal year end 30-Jun	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	113.7	82.1	55.1	30.6	24.2
EV/EBITDA adjusted (x)	64.4	42.1	26.8	15.8	12.7
P/BV (x)	19.8	10.0	6.4	7.2	5.6
Dividend yield (%)	0.1	0.1	0.1	0.2	0.2
Per Share Data (Rs)					
EPS adjusted	3.51	4.86	7.24	13.03	16.51
EPS reported	3.51	4.86	7.24	13.03	16.51
BVPS	20.14	39.91	62.62	55.61	71.19
DPS	0.50	0.51	0.36	0.65	0.83
Profit & Loss (RsM)					
Net sales	10,528	18,678	31,079	56,094	76,930
Operating expenses	-9,753	-17,465	-29,108	-52,555	-72,099
EBIT	**775**	**1,212**	**1,971**	**3,539**	**4,831**
Net interest expense	-275	-335	-640	-860	-1,410
Non-operating/exceptionals	31	42	800	100	100
Pre-tax profit	**531**	**919**	**2,131**	**2,779**	**3,521**
Tax	-145	-277	-682	-889	-1,127
Extraord./Min.Int./Pref.div.	0	0	-400	0	0
Reported net income	**386**	**642**	**1,049**	**1,890**	**2,394**
Adjusted earnings	386	642	1,049	1,890	2,394
Adjusted EBITDA	909	1,420	2,270	4,070	5,574
Growth Rates (%)					
Sales	60.1	77.4	66.4	80.5	37.1
EBIT adjusted	68.0	56.3	62.6	79.5	36.5
EBITDA adjusted	65.3	56.3	59.8	79.3	36.9
EPS adjusted	69.4	38.5	48.9	80.1	26.7
Cash Flow (RsM)					
Operating cash flow	**-403**	**-2,626**	**-1,085**	**381**	**-2,023**
Depreciation/amortization	133	208	299	531	743
Net working capital	-1,020	-3,610	-2,575	-2,089	-5,160
Investing cash flow	**-1,145**	**-1,335**	**-1,935**	**-1,166**	**0**
Capital expenditure	-1,145	-1,335	-1,935	-1,166	0
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**1,133**	**5,565**	**4,723**	**3,642**	**6,739**
Borrowings	496	3,152	1,983	2,749	6,875
Dividends paid	-63	-77	-59	-107	-135
Change in cash	**-415**	**1,604**	**1,703**	**2,858**	**4,717**
Balance Sheet (RsM)					
Total assets	**6,651**	**14,174**	**21,153**	**26,388**	**38,862**
Cash & cash equivalent	215	218	300	5	5
Accounts receivable	123	170	255	307	422
Net fixed assets	2,295	3,955	5,169	8,509	11,294
Total liabilities	**4,441**	**8,916**	**12,073**	**18,324**	**28,539**
Accounts payable	1,271	2,298	3,189	5,955	8,583
Total Debt	2,862	6,014	7,997	10,746	17,620
Shareholders' funds	**2,215**	**5,269**	**9,080**	**8,064**	**10,323**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	8.6	7.6	7.3	7.3	7.2
ROE adjusted	24.4	17.1	14.6	22.0	26.0
ROIC adjusted	15.6	12.4	10.6	15.3	15.0
Net debt to equity	119.5	110.0	84.8	133.2	170.6
Total debt to capital	56.4	53.3	46.8	57.1	63.1

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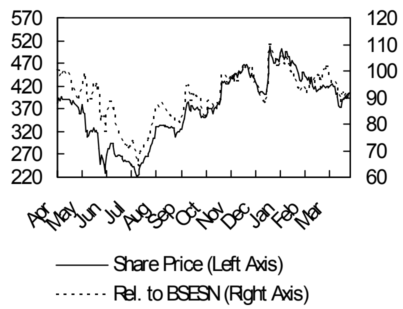
Figure 2. Pantaloon – Stock Performance

(%)	3M	6M	12M
Absolute	(15.4)	14.4	4.3
Rel. to .BSESN	(10.7)	8.8	(12.4)

Source: Datastream

Figure 3. Pantaloon – Stock Price relative to Sensex



Source: Datastream

Upgrade to Buy, Price Target Rs500

We upgrade Pantaloon to Buy after raising our target price to Rs500 from Rs212 earlier. We have maintained a Sell rating on the stock for almost two years, maintaining that risk-reward was unfavorable, given that already high valuations did not leave scope for error in Pantaloon's aggressive expansion to new formats. The stock has underperformed the Sensex by 12.4% over the last 12-months, but we now believe that triggers are in place to reverse this trend. In the near term, we believe that key upside triggers will come from stake sales (likely to private equity and strategic partners) in subsidiaries.

Over the last 12-18 months, Pantaloon has demonstrated a smooth roll out to new formats, albeit slightly delayed. Additionally, it is looking to unlock value from its subsidiaries, which are being scaled up. We now believe that the risk profile of the business is much lower than we gauged earlier (we are also reducing our risk rating on the stock from High to Medium), and that Pantaloon is now better positioned to grow from its current base. While we are cognizant of the emerging competitive landscape, we believe that Pantaloon has sustainable competitive advantages to take on competition over the next few years. The key sources of competitive advantage for Pantaloon emanate from: 1) strong brands and well established retail formats; 2) judicious product mix; 3) below market rentals that are locked in through long-term leases; and 4) longstanding experience in understanding consumer behaviour and preferences of a highly heterogeneous population, comprising differing cultures, languages and tastes across India. We assume slowing same store sales growth, delay in expansion plans and declining margins into our earnings estimate for Pantaloon, which we believe captures the risk of increasing competition.

Our higher target price is driven by 1) raising EPS estimates for FY08E by 11.6%; 2) rolling forward our target P/E multiple from FY07E to FY08E, with FY08E EPS growth estimate of 31%; and 3) incorporating the value of subsidiaries (Home Solutions and Future, which have now been materially scaled up, and account for Rs110 per share based on our estimates. We have still not attributed any value to five other subsidiaries – Future Media, Future Logistics, Future Bazaar, Future Brands and Future Knowledge Services. These businesses are now in a nascent stage, but will likely be scaled up over the next 4-6 quarters.

Pantaloon – SOTP Price Target of Rs500

Our price target for Pantaloon is based on sum of the parts. We value parent Pantaloon Retail on our earlier 30x P/E multiple. However, we roll forward our target multiple to FY08E, given Pantaloon is already in 4QFY07 and that the market is likely start discounting FY08E into valuations. Our fair value for the parent company based on 30xFY08E P/E is Rs390. We also revise down our FY07E EPS by 7.9%, taking into account one-time inventory write-off expected in 4QFY07E and equity dilution, which mitigates the positive impact of one time asset sales in 2QFY07E, which we now incorporate into our estimates. We increase our net profit estimates for FY08E by 12.8%, however, FY08E EPS estimate increase is only 1.7%, taking into account equity dilution in Pantaloon.

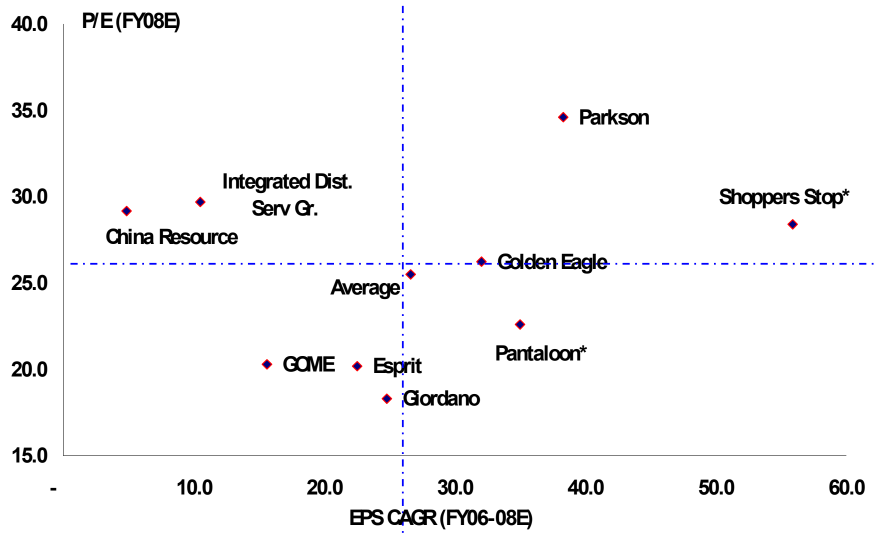
Figure 4. Pantaloon – Earnings Revision Summary

	Net Profits (Rsm)			EPS			DPS		
	Old	New	% Chg.	Old	New	% Chg.	Old	New	% Chg.
FY07E	1139	1,049	-7.9	8.6	8.0	-7.9	0.4	0.4	-17.8
FY08E	1693	1,890	11.6	12.8	13.0	1.7	0.6	0.7	1.8

Source: Company Reports and Citigroup Investment Research estimates

We benchmark Pantaloon's valuations against early-stage valuations for Chinese retailers, which we believe have similar characteristics to Indian retailers. Our 30x valuation multiple is also benchmarked against our regional retail universe, and is at a premium of almost 100%. We expect a two-year EPS CAGR of 35% for Pantaloon, vs. a 30% CAGR for our Asian retail universe.

Figure 5. Asian Retail Universe – P/E v/s 2-year EPS CAGR



Source: Company reports; Citigroup Investment Research estimates; * P/E adjusted for subsidiary values

Figure 6. Asia Retail Sector – Valuation Summary

Company	Ticker	Rating	P/E 2007	P/E 2008	EV/EBITDA 2007	EV/EBITDA 2008	Dividend Yield 2008	RoE 2008	RoCE 2008	EPS CAGR 2006-08E
Golden Eagle Retail	3308.HK	1M	37.33	25.82	16.86	11.82	2.1%	41%	65%	32.04
Parkson Retail	3368.HK	2L	49.65	34.81	25.83	19.68	1.5%	35%	47%	38.31
China Resources	0291.HK	3L	32.96	31.49	17.08	15.71	2.8%	9%	8%	4.85
Esprit	0330.HK	1L	24.77	19.92	17.52	13.84	3.7%	52%	64%	22.52
GOME	0493.HK	1M	25.09	20.38	19.13	14.76	1.5%	12%	14%	30.68
Giordano	0709.HK	3L	18.12	17.23	7.78	7.41	5.5%	15%	22%	24.79
Integrated Dist.	2387.HK	1L	45.81	33.83	24.31	19.42	2.0%	22%	16%	10.50
Pantaloon	PART.BO	1M	55.1	30.6	25.8	14.4	0.2%	23%	19%	30.00
Shoppers Stop	SHOP.BO	3M	58.6	45.2	34.2	25.7	0.5%	15%	14%	33.00
Average			**37.6**	**28.2**	**21.1**	**16.3**	**2.2%**	**25.0%**	**29.9%**	**25.80**

Source: Citigroup Investment Research estimates

We value the Home Solutions subsidiary benchmarked off the valuation used for recent stake sale in the company to private equity players. Home Solutions subsidiary offloaded a 15% stake to private equity investors, valuing the subsidiary at Rs7.5bn-Rs14bn. We use a mid-range valuation, valuing the Home Solution subsidiary at Rs10bn. We also use a 1.2x Market Cap/Sales multiple, benchmarked off Pantaloons sales multiple valuation, which returns a value of Rs11bn for the Home Solution subsidiary. We use a sales multiple, given that Home Solutions is still in a nascent stage and that FY08E earnings do not fully reflect the potential margin profile of the business. Our fair value per share for the Home Solutions subsidiary is Rs60 per share, valuing the subsidiary at Rs10bn, in which Pantaloon has 85% stake.

We attribute per share value of Future Capital, Pantaloon's 74% subsidiary at Rs50. We value the NPV of cash flows to Pantaloon from the three 7-year close ended funds, where Pantaloon earns a 2%-2.5% management fee, and a 20% carry over 8% hurdle rate of return on equity (Pantaloon has leveraged the funds 1:1). We assume 15% increase in the fund NAV every year, and a 13% rate to calculate NPV of Pantaloons cash flows. Our sum of the parts valuation summary is enumerated below:

Figure 7. Pantaloon – Sum of the Parts Valuation Summary

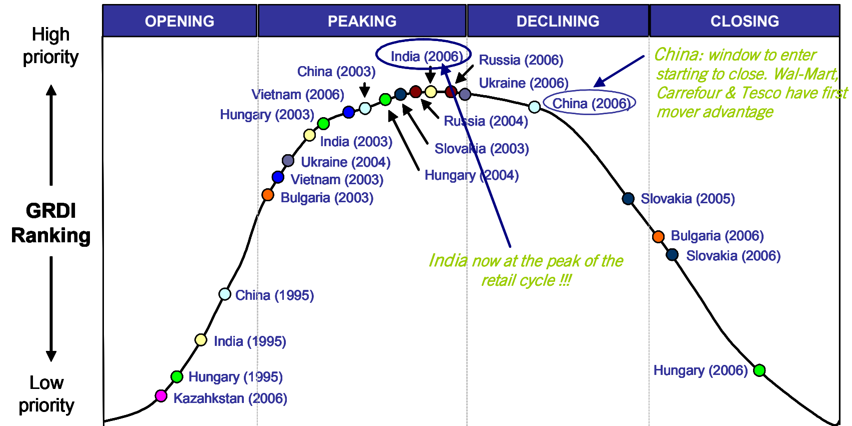
Business	Valuation Methodology	Per Share Value (Rs)
Pantaloon	30xFY08E P/E, benchmarked off trading multiples of Asian peer group	Rs390
Home Solutions	Valued at Rs10bn, using mid-point of stake sale valuation and 1.2x FY08E market cap / sales valuation	Rs60
Future Capital	Valued at NPV of cash flows to Pantaloon, assuming annual 15% fund NAV improvement and 13% discount rate	Rs50
Total		**Rs500**

Source: Company Reports and Citigroup Investment Research estimates

First mover advantage to the fore

We believe that Pantaloon is well positioned along a peaking window of opportunity for the Indian retail sector. We refer here to a study undertaken by AT Kearney that clearly shows India at the peak of the market attractiveness cycle. What this means is that based on a comprehensive criterion, the urgency to enter the Indian market is currently at its most intense. Pantaloon has been amongst the first movers to take advantage of this window of opportunity.

Figure 8. Window of opportunity analysis (based on the Global Retail Development Index rankings for 95-06; refer to figure 14 for the 2006 ranking)



OPENING	Monitor market; consider sending research team	Open sourcing office or step up retail stores; test the market	Scale up openings to capture market share	Determine market position; reevaluate strategy as needed
FORMATS	Not applicable	Consider supermarkets and hypermarkets, cash and carry, and convenience stores over other formats as they have higher success rates	Consider discounter models	No pattern identified
LABOR	Identify skilled labor pool for market	Hire and train local talent; create balance with expatriate employees	Switch balance from expatriate to local staff	No pattern identified

Source: A.T. Kearney

While Pantaloon has so far has been able to expand at a rapid pace, and has really not faced any material competitive challenges, the landscape is likely to change over the next 2-3 years. Large business houses like Reliance, Tatas, Bharati (through a Joint Venture with Wal-Mart), and the Birla group are planning aggressive entry into retail. It is in this environment, that we believe that Pantaloon's business model will be tested the most. While we do expect sales growth and margins for incumbents like Pantaloon to be adversely impacted, we believe that company has some strong first mover advantages, which will continue to drive strong growth for the company. The key advantages, to our mind are: 1) Strong brands and well established retail formats; 2) Judicious product mix; 3) below market lease rental, which are locked in; and 4) Long standing experience of understanding the complex heterogeneous Indian consumer.

Figure 9. India – Retail Expansion Plans of Various Players

Company	Location	Current Retail Formats	Targeted Expansion Plans	Investment Outlay
Reliance Retail	Pan India	Supermarkets, Hypermarkets, Specialty Stores	100m sq. ft. by FY11	US$5bn-US$6bn
Bharti-Wal Mart	Pan India	Hypermarkets	10m sq. ft (55 Stores) by FY10	US$2bn-US$2.5bn
AV Birla Group	Pan India	Supermarkets	NA	US$1bn-US$1.5bn
Subiksha	Pan India	Supermarket	1300 stores by end 2007	NA
Hypercity	Pan India	Hypermarkets	7m sq. ft. by FY15	US$125mUS$150m
Piramyd Retail	Maharashtra	Department Stores, Supermarkets	0.8m sq ft (17 hypermarkets and 69 supermarkets by 2008)	US$125-US$150m
RPG Retail	Pan India	Hypermarkets, Supermarkets	5m sq. ft. by 2008 (57 hypermarkets and 200 music stores)	NA
Tata Group	Pan India	Hypermarkets, Department Stores, Consumer Electronics	60Croma stores by 2009 by Infinity, 27 Trent stores via the JV with DLF	NA

Source: India Retail Report 2007

We enumerate below in what we believe are the key sources of competitive advantages for Pantaloon, emanating from its first mover positioning in the organized retail segment:

1. Strong brands and well-established retail formats: Pantaloon besides its scale has also created well-established and diversified formats with strong brand names. The Big Bazaar and the Food Bazaar brands are now household names and are well established as “value for money” hypermarkets. On the other hand, Pantaloon and Central are well recognized lifestyle stores. Same store sales growth for value as well as the lifestyle formats continuous to be well over 20%. Pantaloon has also recently ventured into the home interiors segment through its Home Town store. The home town store is a first of its kind store in India that caters to all home interior needs, addressed through a wide range of products such as hardware, sanitary ware, furniture, home textiles, furnishings, building material, home appliances and accessories.

Figure 10. Big Bazaar had thousands of customers waiting to enter the store at its annual republic day sale

Source: Citigroup Investment Research

Figure 11. A weekend sale at a Big Bazaar Outlet

Source: Citigroup Investment Research

Figure 12. Up market lifestyle format Central Mall

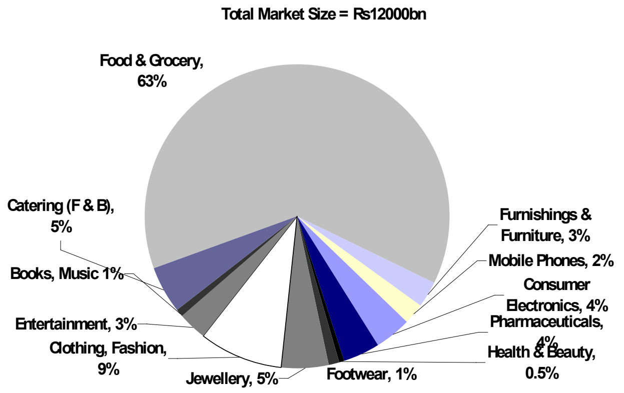
Source: Citigroup Investment Research

Figure 13. Recently launched Home Town store

Source: Citigroup Investment Research

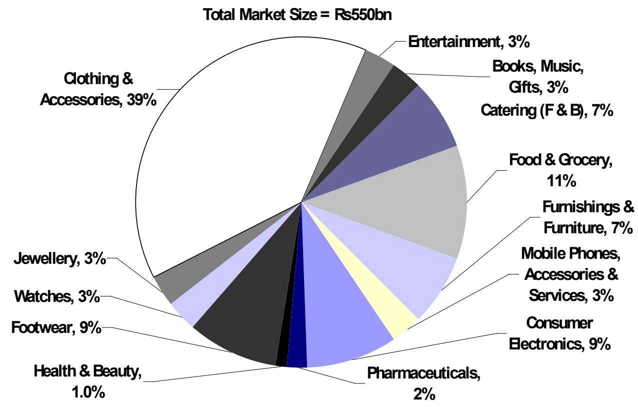
2. Judicious product mix: India's overall retail market is dominated by the food & grocery segment, which commands 63% of the total retail share. However, with in the organized retail segment, food & groceries constitute only 11% of total retail sales. On the other hand, clothing & accessories command 39% market share of organized retail, while commanding only 9% share of total retail spend. Thus, food & beverages segment seems to be presenting best growth opportunity for organized retailers.

Figure 14. India – Segmental Break Up of Total Retail Market



Source: Images retail

Figure 15. India – Segmental Break Up of Organized Indian Retail Market



Source: Images retail

However, It is important to have a judicious mix of non food and food segments in our view – while apparel has higher margin profile (typical gross margins of 35%-50%) but low inventory turns (and therefore lower capital efficiency), margins for food and groceries are low (gross margins of 10%-15%), but this segment has high inventory turns, and therefore higher capital efficiency. In addition, the supply chain for the foods business in India is highly fragmented and infrastructure is underdeveloped, making large-scale and consistent sourcing difficult.

Figure 16. India – Food Supply Chain Infrastructure and Margin Structure

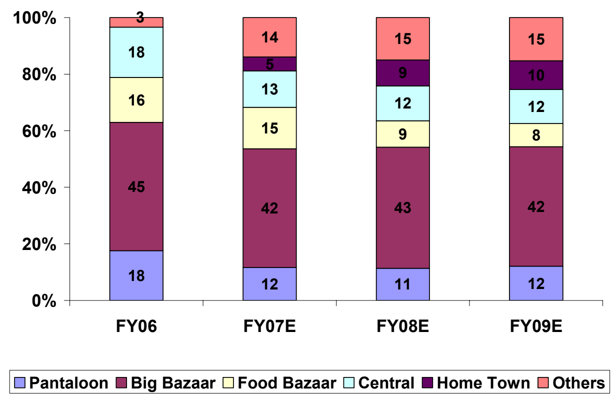
	Supply chain structure	Base case margins*
Fresh fruits and vegetables	• Fragmented (regional) supplier base • 2–5 intermediaries between producer and retailer	• ~20%
Meat and poultry	• Few suppliers for packaged meats with regional/ national reach	• 10–12%
Milk and dairy products	• Few suppliers of processed and packed foods with regional/ national reach	• 12–15%
Staples	• 3-5 intermediaries (including processor) between producer and retailer	• 10–15%
Packaged foods	• Many suppliers with regional/ national supply chain • Smaller suppliers for local products (e.g. mixtures etc.)	• 12–15%
FMCG/ Electronics	• Organized, tiered distribution structure • Managed by producer, e.g., Unilever, LG	• 8–10%

- **Low average margins: 12–20%**
- **Margin structure biased towards producers in a few categories**
  - **FMCG**
  - **Electronics**
- **Margin 'wastage' due to middlemen, and absence of 'quality' supply chains in other categories**

Source: McKinsey & Company

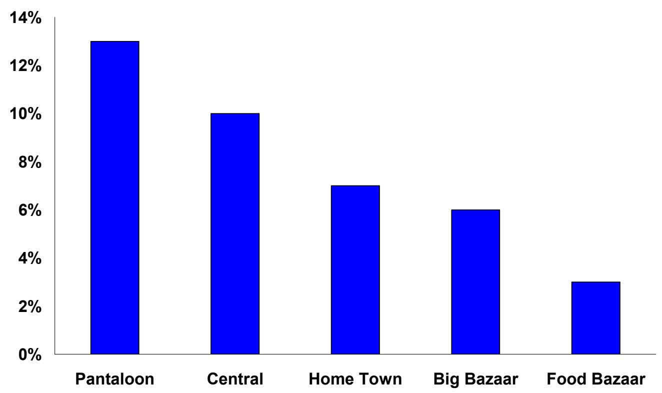
Pantaloon has created a judicious mix of apparel & accessories, food and grocery and household products. Now, almost 30% of its sales come from the lifestyle formats (mainly apparel, cosmetics and accessories) while remaining sales are from the value formats. Going forward, Pantaloon is looking to reduce the contribution of foods to overall sales, with total space dedicated to Food Bazaar likely to decline from 16% of overall space in FY06 to 8% of total space by FY09E, based on our estimates. Contribution from new formats like Home Solutions is likely to increase, while the Big Bazaar format contribution is likely to remain stable. From a margin perspective, Pantaloon's EBITDA margin is the highest amongst all formats, close to 13%, while Food Bazaar has the lowest EBITDA margin profile of about 3%.

Figure 17. Pantaloon – Percentage Retail Space Mix for Retail Formats



Source: Company reports; Citigroup Investment Research estimates

Figure 18. Pantaloon – EBITDA Margin Profile of Retail Formats



Source: Company reports; Citigroup Investment Research estimates

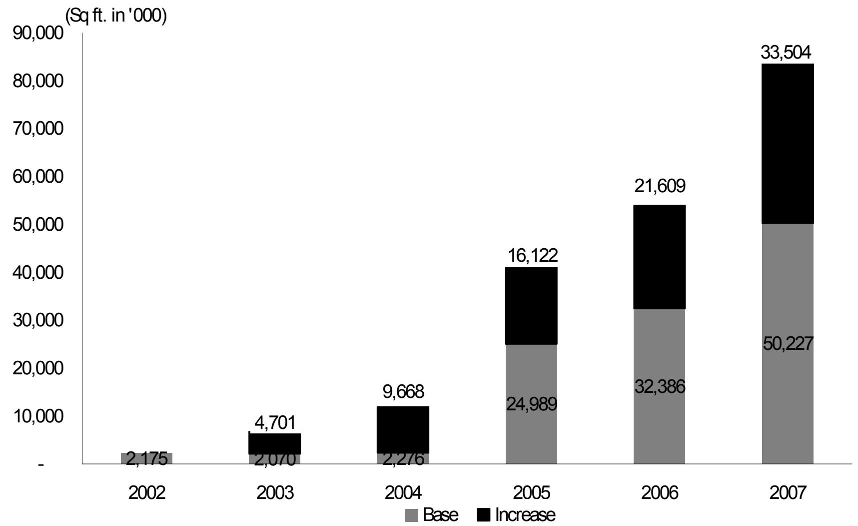
3. Below-market rentals: One of the major competitive advantages for Pantaloon is that it has been able to lock in retail space at much lower than average rents. The company typically locks in retail space with long-term leases with nine-year to 25-year tenors. Average per sq. ft. rent for Pantaloon is currently about Rs45 per sq. ft. per month, against average mall rentals of Rs80-Rs300 in tier I cities (high street rentals are even higher). Pantaloon, which is a key anchor tenant for mall developers, has been able to garner significant rent advantage, with rentals 40%-60% below some retailers that enjoy anchor tenant status. However, with many new players in the fray, demand for retail space is rising and mall space supply is likely to be fall short of demand over the next 2-3 years, driving up rents. Already, rents for retail space have increased by 40%-80% across most tier-I cities over the past 12months. However Pantaloon has already locked in 25m sq. ft. of retail space for its expansion plans over next three years, so it should not see significant pressure on rent costs. We are building in a 50bps increase in rents (as % of sales) into our estimates over the next 2 years. We would like to highlight that Pantaloon's growth ambitions are not overriding business sense, and it really is not in a "land grab" mode. We understand from Pantaloon's management that they have not signed any new lease agreements for the past six months as they believe that current rentals being demanded by mall developers do not make business sense. Pantaloon management expects rents to cool over the next few months and would look to enter fresh agreements only following a correction.

Figure 19. Pantaloon – Lease Rentals in Tier-1 cities: High Streets and Malls

Rs/Sq ft/Month	Minimum	Maximum	Mean
NCR	40	600	320
MMR	80	500	290
Bangalore	50	300	175
Kolkata	25	250	138
Pune	50	150	100
Hyderabad	38	158	98
Chennai	50	130	90

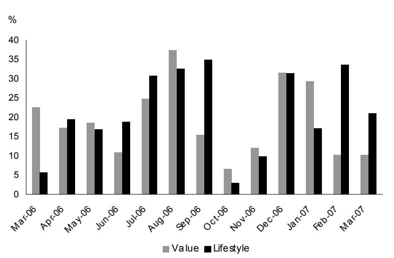
Source: Knight Frank India: Citigroup Investment Research estimates

Figure 20. India – Growth in supply of mall space



Source: India Retail Report 2007

Figure 21. Pantaloon – Same Store Sales growth Trend (%)



Source: Citigroup Investment Research

4. Experience of understanding the complex Indian consumer: Pantaloon tends to localize its Food Bazaar and Big Bazaar stores, keeping in mind consumer tastes in a particular region. Pantaloon has also over the years gained a first-hand understanding of consumer behaviour and preferences of a highly heterogeneous population, comprising many different cultures, languages and tastes across different states. For instance, for its value Hypermarket, Big Bazaar, Pantaloon has created a store layout that caters to family groups shopping together (a typical Indian trait) and seems slightly chaotic. Pantaloon management maintains that Indians are accustomed (and in some cases prefer) a "chaotic" shopping environment and the Big Bazaar tends to replicate a similar environment. We have seen also seen ample use of local language signage and product localization across stores. In addition, we have seen some great innovations by Pantaloon to drive footfalls – it offers consumers coupons to spend in its Big Bazaar stores in exchange for household junk (newspapers, old clothes, metal scrap etc). Pantaloon further sells these to the recycling industry (management of the process itself is outsourced, so Pantaloon does not waste resources). At any

given time, one can see hordes of customers queued up outside Big Bazaar stores to exchange junk for purchase coupons. Pantaloon's stores have continued to attract higher footfalls and ticket sizes, evident from its continued strong same store sales trend.

Figure 22. Customers queued up outside Big Bazaar to exchange 'junk' for purchase coupons

Source: Citigroup Investment Research

New format roll out seems on track

Over the past two years, we have been skeptical of Pantaloon's plans to expand at an aggressive pace and diversify into numerous new formats. Our skepticism was driven by Pantaloon's foray into numerous new segments and retail formats and concerns whether Pantaloon had the execution capabilities to deliver such rapid expansion. However, successful roll out of the new formats over last two years, albeit slightly delayed, has made us rethink. While we do not deny the execution risk entailed in the aggressive expansion plans going forward, we believe that Pantaloon now has the scale to be able to absorb losses arising from any formats that do not succeed. Till two years back, the company had four store formats (Pantaloon, Big Bazaar, Food Bazaar and Central). It has now expanded its store formats to over 12. We are impressed by Pantaloon's ability to gauge customer response and respond accordingly. We have observed that Pantaloon has been fairly quick on curtailing formats that do not perform to its expectations. For example, Pantaloon has curtailed its growth plans for its Fashion Station stores, which have not delivered targeted sales per square foot.

We would also like to highlight that older formats will remain the bread and butter for the company, besides the Home Town format, on which Pantaloon is betting big. Overall, we expect five formats (Pantaloon, Big Bazaar, Food Bazaar, Central and Home Town) to contribute over 85% of sales by FY09E.

Home Town: Potential for Next Big Format

Pantaloon recently rolled out its home interiors format, Home Store. The home town store is a first of its kind store in India that caters to all home interior needs, addressed through a wide range of products such as hardware, sanitary ware, furniture, home textiles, furnishings, building material, home appliances and accessories. Typical store size would be 125,000-150,000 sq. ft. Pantaloon plans to roll out 10-12 such stores over the next two years. Home town is part of Pantaloon's Home Solutions subsidiary (which we value at Rs60 per share). Besides Home Town stores, the home solutions subsidiary has four other store formats: consumer electronics, furniture and mobile phones. Our key operating assumptions for the Home Solutions subsidiary are enumerated below. Our retail space assumptions only capture stand alone stores, and do not capture space utilized by these formats in the Big Bazaar stores to avoid double counting. We expect the Home Town stores to continue to contribute over 50% of sales of this subsidiary.

Figure 23. Home Solutions Subsidiary – Operating Assumptions

	FY07E	FY08E	FY09E
E-Zone			
Sales (Rsm)	750.0	2250.0	3500.0
Growth (%)		*200.0*	*55.6*
Total Space (Sq Feet)	150000.0	300000.0	400000.0
Sales / Sq Ft. (Rs)	10000.0	10000.0	10000.0
Electronic Bazaar			
Sales (Rsm)	325.0	975.0	1250.0
Growth (%)		*200.0*	*28.2*
Total Space (Sq Feet)	32500.0	97500.0	125000.0
Sales / Sq Ft. (Rs)	10000.0	10000.0	10000.0
Collection i			
Sales (Rsm)	337.5	900.0	1237.5
Growth (%)		*166.7*	*37.5*
Total Space (Sq Feet)	112500.0	187500.0	225000.0
Sales / Sq Ft. (Rs)	6000.0	6000.0	6000.0
Furniture Bazaar			
Sales (Rsm)	288.0	888.0	1500.0
Growth (%)		*208.3*	*68.9*
Total Space (Sq Feet)	96000.0	200000.0	300000.0
Sales / Sq Ft. (Rs)	6000.0	6000.0	6000.0
Home Town			
Sales (Rsm)	450.0	4,100.0	8,200.0
Growth (%)		*811.1*	*100.0*
Total Space (Sq Feet)	225,000.0	800,000.0	1,250,000.0
Sales / Sq Ft. (Rs)	8,000.0	8,000.0	8,000.0
Gross Sales	**2150.5**	**9113.0**	**15687.5**
Total Area (sq ft)	616000.0	1585000.0	2300000.0
Gross Margins (%)			
E-Zone	11%	11%	11%
Electronic Bazaar	10%	10%	10%
Collection - i	45%	45%	45%
Furniture Bazaar	35%	35%	35%
Home Town	25%	25%	25%
Total Gross Profit	**480.2**	**2085.8**	**3641.9**
Gross Margins (%)	*22.3*	*22.9*	*23.2*
EBITDA Margins (%)			
E-Zone	-5%	3%	3%
Electronic Bazaar	-5%	2%	2%
Collection - i	-5%	10%	10%
Furniture Bazaar	-5%	9%	9%
Home Town	-5%	6%	6%
EBITDA	**-107.5**	**502.9**	**880.8**
EBITDA Margins (%)	*-5.0*	*5.5*	*5.6*
Depreciation	-50.0	-77.5	-57.2
Interest	-40.0	-200.0	-360.0
PBT	**-197.5**	**225.4**	**463.6**
Tax	59.3	-67.6	-139.1
Tax Rate (%)	*30%*	*30%*	*30%*
Net Profit	**-138.3**	**157.8**	**324.5**

Source: Company Reports and Citigroup Investment Research estimates

We recently visited the first Home Town store opened in Noida in the National Capital Region of Delhi. We came back fairly impressed with the format, and see tremendous potential for this format going forward. Typically, home interiors segment in India is dominated by the unorganized segment, entailing multiple points of purchase and services. Home Town offers a convenience proposition of all products and services under one roof – which scores significantly over the unorganized segment. We are also enthused by the store outlay, with demarcated areas for various products segments. The product range at the store itself was impressive, with ample choices across products, suiting most price brackets. However, we were most impressed by the display of live models of kitchens, living rooms, bedrooms and bathrooms – clearly aspirational for middle income consumers. The store also offers credit to consumers. Management indicated IRR on credit in the range of 20%-25%, built into product prices.

Figure 24. Bedrooms on display at the Home Town

Source: Citigroup Investment Research

Figure 25. Bathrooms on display at Home Town

Source: Citigroup Investment Research

Figure 26. Air Conditioning sections at Home Town

Source: Citigroup Investment Research

Figure 27. Tiles and hardware section at Home Town

Source: Citigroup Investment Research

Potential upside from subsidiaries

Pantaloon has forayed into businesses, which are ancillary to its retail business, but can potentially unlock significant value going forward. These businesses are held in subsidiaries, which could see equity infusion over the next 3-4 quarters as these are scaled up. We have not factored these subsidiaries into our sum of the parts valuation. However, we believe that if Pantaloon's plans to scale up these businesses remain on track, significant value could be unlocked over next 4-6 quarters. The key subsidiaries that could see equity dilution over next few months include:

- Future Media: Future media, a 100%-owned subsidiary of Pantaloon will manage LCD screens, billboards and hoardings in all Pantaloon stores, as well as third party stores. The company has already rolled out operations and an initial team of 25 employees has been put in place. LCD screens have already been put up at the Home Town store located in Noida.
- Future Logistics: This is a logistics management company, which now manages logistics for Pantaloon, but over next 1-2 years will also transit to managing logistics for third parties. The company has about 80 employees on board, and according to the Pantaloon management is exploring options to tie up with an international strategic partner.
- Future Bazaar: Future Bazaar is Pantaloon's e-tailing venture, which currently has a run rate of Rs10m per month sales, but growing rapidly.
- Future Brands: The Future Brands subsidiary owns the rights to all of Pantaloons private label brands, and has been entrusted to scale up all of these brands nationally. Future Brands will earn royalties from franchising out the brands.

Figure 28. Pantaloon – Subsidiaries and Joint Ventures

Subsidiaries	Pantaloon's Stake	Format	Current CIR per share value (Rs)
Home Solutions	85%	Home interior retailing	60
Future Capital	74%	Real estate and private equity funds	50
Future Media	100%	Advertising in retail outlets	0
Future Bazaar	100%	E-tailing	0
Future Logistics	100%	Logistics management	0
Future Brands	100%	Brand management and franchisee	0
Convergem	100%	Communications	0
Joint Ventures			
Gini & Jony	50%	Kids wear retailing	0
Capital Foods	33%	Ready to eat food	0
Generali	58%	Insurance	0
Liberty Shoes	51%	Footwear retailing	0
Planet Sports	49%	Sports and apparel retailing	0
Galaxy Entertainment	16%	Leisure and entertainment	0

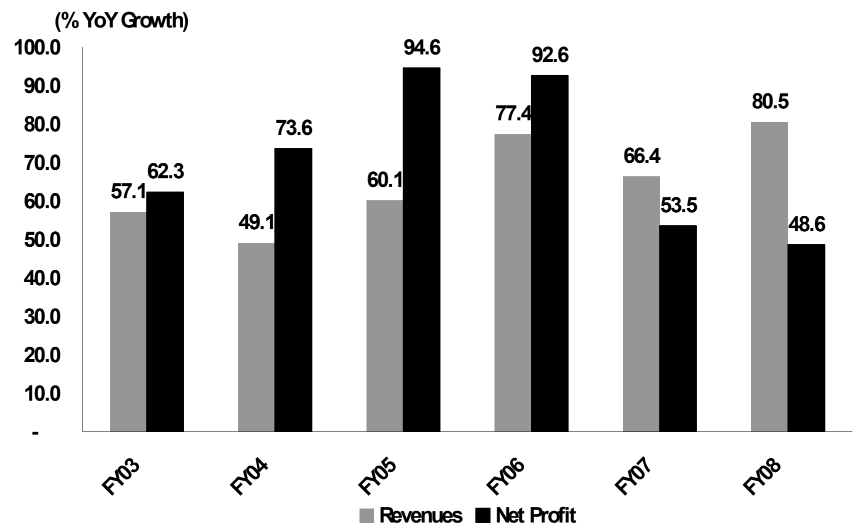
Source: Company Reports; Citigroup Investment Research estimates

EPS CAGR of 35% over FY07E-FY09E

We forecast EPS CAGR of 35% over FY07E-FY09E for standalone Pantaloon (excluding the subsidiaries), driven by aggressive new store expansion and continued strong same store sales growth. We estimate total retail space for standalone Pantaloon to increase from 3.9m sq. ft. by FY07E to 10.1m sq. ft. by FY09E. We estimate total retail space, including the home solutions subsidiary to increase from 4.5m sq. ft. to 12.4m sq. ft. over the same period. Our space addition estimates are significantly below management guidance (looking at 30m sq. ft. by FY11E), as we factor in store opening delays due to malls being behind schedule and delayed related to regulatory clearances.

We forecast sales growth CAGR of 57% for the standalone entity over FY07E-FY08E. However, rising interest cost and margin pressure are likely to pare net profit growth.

Figure 29. Pantaloon – Sales and EPS growth trend (%)



Source: Company reports; Citigroup Investment Research estimates

Figure 30. Pantaloon – Sales Growth Assumptions (Rupees in Million, Percent)

	FY05	FY06	FY07E	FY08E	FY09E
Pantaloon					
Sales (Rsm)	2,559.6	3,031.2	3,594.7	6,750.0	10,125.0
Growth (%)	23.2	18.4	18.6	87.8	50.0
Total Space (Sq Feet)	278,500	474,550	532,550	1,000,000	1,500,000
No. of Stores	12.0	21.0	23.0	35.0	40.0
Sales / Sq Ft. (Rs)	7,839.5	7,286.5	7,500.0	7,500.0	7,500.0
Big Bazaar					
Sales (Rsm)	4,256.4	8,153.4	14,672.7	28,687.5	40,162.5
Growth (%)	83.8	91.6	80.0	95.5	40.0
Total Space (Sq Feet)	841,800.0	1,220,200.0	1,918,000.0	3,750,000.0	5,250,000.0
No. of Stores	19.0	29.0	70.0	50.0	80.0
Sales / Sq Ft. (Rs)	8,357.8	8,153.4	8,500.0	8,500.0	8,500.0
Food Bazaar					
Sales (Rsm)	2,413.3	4,918.5	9,039.7	11,064.7	13,764.7
Growth (%)	110.7	103.8	83.8	22.4	24.4
Total Space (Sq Feet)	269,608.0	428,308.0	669,608.0	819,608.0	1,019,608.0
No. of Stores	28.0	45.0	56.0	68.0	85.0
Sales / Sq Ft. (Rs)	14,022.3	14,904.5	15,000.0	15,000.0	15,000.0
Central					
Sales (Rsm)	1,614.5	3,253.3	766.1	3,447.9	2,940.0
Growth (%)	1,641.6	101.5	5.0	7.0	8.0
Total Space (Sq Feet)	478,000.0	478,000.0	587,440.0	1,080,000.0	1,500,000.0
No. of Stores	3.0	4.0	5.0	9.0	13.0
Sales / Sq Ft. (Rs)	5,557.9	6,806.1	7,000.0	7,000.0	7,000.0
Fashion Station					
Sales (Rsm)	29.3	174.9	499.5	900.0	1,575.0
Growth (%)			185.5	80.2	75.0
Total Space (Sq Feet)	32,000.0	91,500.0	111,000.0	200,000.0	350,000.0
No. of Stores	1.0	5.0	6.0	11.0	19.0
Sales / Sq Ft. (Rs)	4,075.7	3,469.9	5,000.0	5,000.0	5,000.0
Brand Factory					
Sales (Rsm)			506.3	1,743.8	3,112.5
Growth (%)				244.4	78.5
Total Space (Sq Feet)			135,000.0	330,000.0	500,000.0
Sales / Sq Ft. (Rs)			7,500.0	7,500.0	7,500.0
Other Sales	312.2	300.0	2,000.0	3,500.0	5,250.0
Revenues	**11,185.3**	**19,831.3**	**31,079.0**	**56,093.9**	**76,929.7**
% Growth	72.8	77.3	56.7	80.5	37.1
Less: Inter segment Sales	(678.3)	(1,316.4)	(1,243.2)	(2,243.8)	(3,077.2)
% of Revenues	6.1	6.6	4.0	4.0	4.0
Gross Sales	**10,507.0**	**18,514.9**	**29,835.8**	**53,850.1**	**73,852.5**
Excise/VAT	(324.4)	(929.9)	(1,243.2)	(2,243.8)	(3,077.2)
Net Sales	**10,182.6**	**17,585.0**	**28,592.6**	**51,606.4**	**70,775.3**
% Growth		72.7	62.6	80.5	37.1
Sales per sq/ft (Rs.)	8,567.5	8,719.3	8,869.0	8,768.6	8,479.3
Other Operating Income	345.3	1,092.7	2,185.5	4,370.9	8,741.8
Total Income	**10,527.9**	**18,677.8**	**30,778.1**	**55,977.3**	**79,517.1**
% Growth		77.4	64.8	81.9	42.1

Source: Citigroup Investment Research

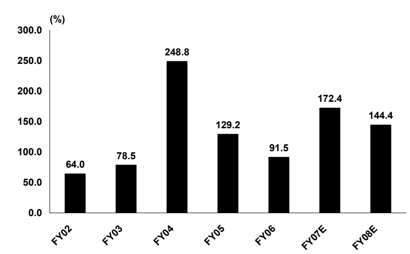
We expect margins for Pantaloon to decline marginally going forward, driven by rising rentals and wage bill. Some of the margin pressure is likely to be mitigated by operating leverage with the business scaling up rapidly. Our key margin assumptions are enumerated below:

Figure 31. Pantaloon – Key Cost Assumptions (Rupees in Million, Percent)

	FY05	FY06	FY07E	FY08E	FY09E
Total Income	10,527.9	18,677.8	30,778.1	55,977.3	79,517.1
% Growth		*77.4*	*64.8*	*81.9*	*42.1*
Cost of Goods Sold	7,003.1	12,434.3	20,822.9	37,582.9	51,542.9
% of Sales	*66.5*	*66.6*	*67.0*	*67.0*	*67.0*
Personnel Cost	506.5	1,120.7	2,042.3	3,686.2	5,055.4
% of Sales	*4.8*	*6.0*	*6.6*	*6.6*	*6.6*
Manufacturing & Other Expenses	2,109.6	3,702.3	5,943.6	10,754.8	14,757.7
% of Sales	*20.0*	*19.8*	*19.1*	*19.2*	*19.2*
Labor Charges	152.7	206.0	466.2	841.4	1,153.9
% of Sales	*1.5*	*1.1*	*1.5*	*1.5*	*1.5*
Packing Material	124.4	192.0	310.8	560.9	769.3
% of Sales	*1.2*	*1.0*	*1.0*	*1.0*	*1.0*
Mall Maintenance Charges	216.8	336.1	528.3	953.6	1,307.8
% of Sales	*2.1*	*1.8*	*1.7*	*1.7*	*1.7*
Rent	479.7	1,058.2	2,020.1	3,702.2	5,154.3
% of Sales	*4.6*	*5.7*	*6.5*	*6.6*	*6.7*
Advertising	325.5	509.6	870.2	1,682.8	2,231.0
% of Sales	*3.1*	*2.7*	*2.8*	*3.0*	*3.0*
Other Operating Expenses	810.5	1400.4	1747.9	3013.8	4141.4
% of Sales	*7.7*	*7.5*	*5.6*	*5.4*	*5.4*

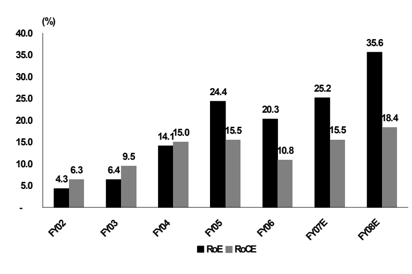
Source: Citigroup Investment Research

Figure 32. Pantaloon – Gearing Trend (%)



Source: Company; Citigroup Investment Research estimates

Figure 33. Pantaloon – ROE and ROCE (%)



Source: Company Reports and Citigroup Investment Research estimates

Gearing to rise on aggressive expansion

We estimate that Pantaloon requires about Rs19.3bn of funding for store expansion over FY07E-FY09E. We estimate that each incremental sq. ft of space requires about Rs2700 of capital – about Rs1200 to fund capital expenditure and Rs1500 for working capital. We expect Pantaloon to fund its expansion through a combination of internal accruals, debt and selling minority stakes in its subsidiaries. Pantaloon management has stated that it is not looking at further equity dilution of the parent company.

We expect gearing (gross debt to equity) for Pantaloon to increase from 0.9x in FY07E to 1.4x by FY08E on account of borrowings needed for expansion.

We expect ROE to improve over FY07E-FY09E due to rapid profit growth and coming off a low base of FY06E and FY07E due to fresh equity infusion. However increasing debt on the books is likely to keep ROCE under check over FY07E-FY09E.

One-time Inventory write-off expected

According to the Pantaloon annual reports, the company values its inventories in the following manner:

- Raw material and stitching material: At cost
- Stores, spares, packaging and branding material: At cost
- Finished goods lying at factory: At lower of cost or net realizable value
- Finished goods lying at retail outlets: Retail price less mark up

Pantaloon uses the 'retail method' to value its finished goods inventories lying in its retail stores (using FIFO method), in accordance with AS-2 (accounting standard 2) of Indian GAAP. The US GAAP also provides for the retail method of inventory valuation for retailing companies that allows retailers to take physical inventory at retail prices and then use a cost-to-retail ratio to convert ending inventory at retail to estimated costs. The retail inventory valuation method is followed by a significant number of leading retailers, globally.

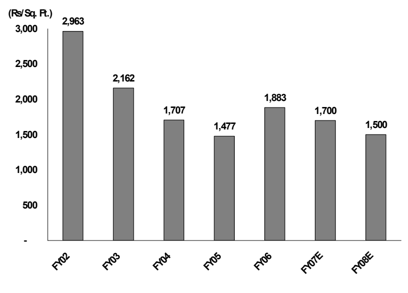
The Indian GAAP standard for retail inventory valuation is enumerated below:

"*The retail method is often used in the retail trade for measuring inventories of large numbers of rapidly changing items that have similar margins and for which it is impracticable to use other costing methods* ***. The cost of the inventory is determined by reducing from the sales value of the inventory the appropriate percentage gross margin.*** *The percentage used takes into consideration inventory that has been marked down to below its original selling price. An average percentage for each retail department is often used.*"

While Pantaloon's inventory valuation methodology is consistent with the Indian GAAP guidelines, the point of contention is the 'mark up' that the company uses to deduct from the retail price. Our discussions with the Pantaloon management suggest the following components of the 'mark up'

- EBITDA Margin (Historically, at about 8% level)
- Sales Tax (Average 4%)
- Promotions / Discounts / Shrinkage (Average 3%)

Figure 34. Pantaloon – Inventory per square feet (Rupees)



Source: Company reports; Citigroup Investment Research estimates

Thus, Pantaloon marks down its inventories by about 15% of retail price, or values the inventory at its retail outlets at about 85% of retail price, which we find aggressive. In our view, a more conservative norm of valuing inventories would be using the value of the purchase order (POI) issued to the vendors, and adding any freight and transportation costs incurred on brining the concerned goods to the respective retail outlets. We understand from the Pantaloon management that they are looking to revert to a more conservative inventory valuation norm (valuing at cost) from FY08 and a one-time inventory write off is expected in 4QFY07. Additionally, management is also looking at writing off store inventory over 365 days. We have incorporated a write off of Rs400m into our FY07E estimates.

There have also been issues pertaining to seemingly high inventory at the store level. While over the years, per sq. ft. inventory has been coming down, there was a sharp increase in FY06. Store inventory per sq. ft. is a function of the store mix, typically the Pantaloon store has the highest inventory on a per sq. ft. basis, while Food Bazaar carries the lowest per sq. ft. inventories. Going forward, we expect overall inventory per sq. ft. to decline, partly driven by change in store mix, and partly through better inventory management systems due to recent implementation of SAP across the organization.

Pantaloon

Company description

Pantaloon is the largest organized modern-format retailer in India, with a presence in apparel, general merchandise, home products and food retailing. It has retail space of about 3.5m sq. ft. with plans to expand to 30m sq. ft. by FY11. Pantaloon retails fashion apparel and accessories through its Pantaloon stores, and general merchandise and food through discount department stores Big Bazaar and Food Bazaar. It has presence in retail property management services through Central Malls, managing retail space for concessionaries fees and a share of sales. It has recently launched Home Town for home interiors, which it plans to expand aggressively. Its real estate investment subsidiary, Kshitij Retail Destinations plans to set up 51 malls across India spanning 14.5m sq. feet in the next three years. Pantaloon also has interests in media, logistics, brand management and e-tailing, through subsidiaries.

Investment Thesis

We rate Pantaloon Buy/Medium Risk (1M) with a target price of Rs500. In the near term, stock upside triggers should come from stake sales in subsidiaries. We are including the Home Solutions and Future Capital subsidiaries into our valuations. We believe that the risk profile of the business has come down, and that Pantaloon is now better positioned to grow from its current base. While we are cognizant of the emerging competitive landscape, we believe that Pantaloon has sustainable competitive advantages: 1) strong brands and well-established retail formats; 2) judicious product mix; 3) below-market rentals locked in with long-term leases; and 4) longstanding experience in understanding Indian consumer behaviour.

Valuation

Our price target is based on sum of the parts. We value parent Pantaloon Retail at Rs390 per share based on 30x FY08E P/E, similar to early-stage valuations for Chinese retailers. Our 30x multiple is also benchmarked against our regional retail universe. We expect a two-year EPS CAGR of 64% for Pantaloon, vs. 30% for our Asian retail universe. We benchmark valuations of Home Solutions against recent stake sales (mid point of Rs7.5bn-Rs10bn). We also use Market Cap/Sales valuation of 1.2xFY08E, at par with Pantaloon's valuations. Our fair value per share for the Home Solutions subsidiary is Rs60 per share. We attribute per share value of Future Capital, Pantaloon's 74% subsidiary at Rs50, based on the NPV of cash flows to Pantaloon from the three 7-year close-ended funds (management fee + carry). We assume a 15% increase in the fund NAV every year, and a 13% discount rate to calculate NPV of cash flows.

Risks

We assign a Medium Risk rating to Pantaloon Retail based on our quantitative risk-rating system. The main downside risks to our target price include: 1) Delay in store opening plans; 2) Legislative changes that allow FDI in retail; 3) Increase in competitive intensity, irrational competition; and 4) Continued pressure on rentals, which could result in lower than expected margins. The main upside risks to our target price and estimates include: 1) Better-than-expected sales growth; 2) Value unlocking in subsidiaries through listing / stake sales; and 3) Any significant acquisitions perceived to be creating value.

Appendix A-1

Analyst Certification

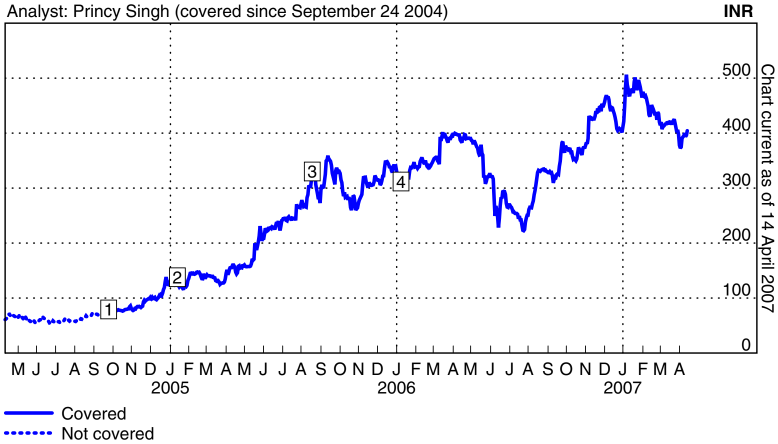
I, Princy Singh, research analyst and the author of this report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

Pantaloon (PART.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Princy Singh (covered since September 24 2004)



#	Date	Rating	Target Price	Closing Price
1:	24 Sep 04	1H	98.25	68.94
2:	13 Jan 05	*3H	*121.19	125.88
3:	18 Aug 05	3H	*185.64	330.20
4:	9 Jan 06	3H	*212.00	323.20

*Indicates change.

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Citigroup Global Markets Inc. or its affiliates expects to receive or intends to seek, within the next three months, compensation for investment banking services from China Resources Enterprise.

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